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**Research Paper**

# The role of central bank policies in corporate financial decision-making

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**ABSTRACT**

The monetary policies of the central bank are measurable, determinants of corporate financial decisions, such as investment, financing of debt, dividend distributions, share repurchases, and allocation of capital. In this study, the impacts of interest rate policy, quantitative easing, forward guidance and reserve requirements on corporate financial policies are analyzed, focusing on firm size and industry differences. The study uses a mixed-method design, including panel data regression which involves aggregating 485 firms in the S&P 500 between 2008 and 2023, and qualitative analysis comprised of major monetary policy cycles during the Global Financial Crisis, the COVID-19 stimulus period, and the aggressive interest-rate hike periods from 2022 to 2023. Results reveal that the increase in the federal funds rate significantly curtails capital investment ($\beta = -0.312$, $p < 0.001$), debt-to-equity ratios ($\beta = -0.185$, $p < 0.001$) and buyback, and stimulates the retention of cash in the balance sheet. But that doesn't happen when interest rates are low: Lower interest rates encourage borrowing and buying up assets, as well as merger and acquisition activity. The findings in the sense that the smaller firms are more sensitive to policy-rate changes than the larger firms. Indeed, it is found that industry-level differences between firms with different leverage ratios, and those with different dividend policies, exist as well. The analysis also identifies the impact of forward guidance and the other policy tools used on managers' expectations and business planning horizons. The results of the work are an important edge for macrofinancial linkages understanding and also useful for the corporate treasurers, strategic financial managers, investors, policy makers, and corporate governance.

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## 1. INTRODUCTION

Central banks play a key role in the modern economy, having at their disposal a set of policy tools that have implications on the macroeconomic environment and thus on the financial behavior of companies. Central banks manipulate the cost and availability of credit, the risk-free rate, and the overall financial system in which corporations operate through interest rate policies, open market operations and forward guidance [1]. It is now more vital than ever to comprehend the impact of these policy signals on the corporate sector, particularly in the context of unprecedented monetary interventions since the 2008 Global Financial Crisis and COVID-19 pandemic.

The financial decision-making process of a company involves a wide variety of decisions, such as dividend policy, cash management, share repurchase programs, the optimization of capital structure and capital investments. All these choices are sensitive, to various extents, to prevailing and anticipated monetary conditions [2]. When the Fed lowers interest rates (and the ECB, or other large central banks), borrowing costs should fall and theoretically spur companies to invest more, leverage more, and return capital to shareholders. On the other hand, the tighter the cycles are, the higher the financing expenses will be, the lower the valuations will go, and, in many cases, more conservative financial planning will be required [3].

The empirical evidence is complex although the relationships are intuitive and clear. The reactions of firms to monetary policy changes are not always positive. The transmission of central bank policies to the firm level financial decisions is moderated by size, sector, credit rating, and access to international capital markets [4]. Furthermore, unconventional policy instruments like quantitative easing (QE), negative interest rate policies (NIRP) and forward guidance add to the complexity of the policy transmission mechanism [5].

This study attempts to answer three key research questions: (1) What is the measurable change in the key financial variables of corporations as a result of changes in the central bank interest rate? (2) Does the variation in firm size and sector explain some of this variation? (3) What is the effect of unconventional monetary policy on the financial strategy of the firm? The study considers these questions in a quantitative panel regression framework as well as in a qualitative policy analysis framework, to better understand the macro-financial linkages between central banks and corporate finance [6].

The rest of the paper is organized as follows: Section 2 summarizes the theoretical and empirical background; Section 3 details the research methodology and data sources; Section 4 discusses and presents the main findings; Section 5 discusses the policy and managerial implications [7].

## 2. RELATED WORK

There are a lot of studies that have been conducted in financial economics about the link between monetary policy and corporate finances. The seminal work of Modigliani and Miller has shown that in the absence of friction in capital markets, options related to financing are not relevant; however, other studies have illustrated that when imperfections exist in the capital markets (information asymmetry, taxes, transaction costs) monetary conditions become very relevant to corporate financial decisions [8]. The literature on the "credit channel" of monetary policy, initiated by Bernanke and Gertler [9] suggests that monetary policy also influences the external finance premium that firms have to pay when they borrow, and thereby widens the real effects of monetary policy through the balance sheet channel.

Past experience has shown clearly that the effect of cutting interest rates is to encourage corporate investment. Faulkender and Petersen discovered that firms that have access to public debt markets react more strongly in times of low rates, by leveraging up, and more strongly in times of tightening, by reducing

leverage, for firms dependent on banks [10]. Likewise, found that the financial constraints were the main cause for the credit market disruptions in the 2008 crisis, as the investment and employment reduction was greater for financially constrained firms than for unconstrained ones [11].

The academic literature on quantitative easing has enriched the theory of how the Fed influences the economy, with the addition of the route via the housing market. Krishnamurthy and Vissing-Jorgensen found that QE programs reduced the cost of long term borrowing for corporations, which resulted in a record amount of bond issuance in the post-GFC period [12]. [13] Found that companies used the QE driven downward trend in long-term rates as an opportunity to lengthen debt maturities, lower rollover risk and boost capital expenditures.

It has been shown that the announcement of the future trajectory of policy rates (the forward guidance) and its effect on the decision of managers to invest also permeates the investment decision of firms beyond the one-period effect from the policy rate [14]. [15] Show that uncertainty, in particular high economic policy uncertainty, which is more closely related to confused monetary policy signals, is important for the transmission of this component of the economy.

Several authors have attempted to analyses the cross-sectional variation of the sensitivity of monetary policy. Gertler and Gilchrist confirmed that banks make disproportionate cuts to small businesses' short-term bank credit when the Fed tightens monetary policy, and they are also less likely to be able to access capital markets [16]. Sector-level studies have also shown that there is not a uniform response to rate change – capital-intensive manufacturing firms are more responsive to rate change than asset-light service sector firms [17]. The effect of monetary policy on corporate dividend and buyback decisions has been examined more recently: it has been found that during low interest rate periods, the level of corporate distributions to shareholders was higher because of the reduction of the opportunity cost of cash [18].

There is a wealth of literature on this subject, but there are some areas that are not addressed. Most of the literature in existence examines either the interest rate policy or unconventional policies individually rather than a comprehensive policy tool kit that can be analyzed as a whole. Second, the rapid tightening cycle of 2022-2023 is an under-studied period of financial stress, having valuable lessons for business financial strength. Third, more systematic treatment of the firm level heterogeneity in size and sector for a single empirical framework is warranted [19]. The purpose of this study is to fill these gaps by taking an integrated look at several policy instruments on a wide panel of firms covering several different monetary policy regimes [20].

## 3. METHODOLOGY

The data analysis approach used in this study is a mixed method, a combination of quantitative econometrics approach of panel data analysis and qualitative approach in the form of historical policy episode analysis. The quantitative part is based on a panel of 485 companies from the S&P 500 index from January 2008 to December 2023. Data for financial variables at the firm level were taken from Compustat and Bloomberg databases, and monetary policy variables were cleaned up by Federal Reserve Bank of St. Louis's Federal Reserve Economic Data (FRED) database.

### 3.1 Data and Variables

The main dependent variables that are investigated are: (i) capital expenditure/total assets (CAPEX/TA), (ii) debt-to-equity ratio (D/E), (iii) dividend payout ratio (DPR), (iv) cash held/total assets (C/TA) and (v) volume of share buyback normalized by market capitalisation. The federal funds rate (FFR) is the primary independent variable, and is measured as the quarterly average rate. The firm size (measured as the log of total assets), the profitability (measured as ROA), the leverage, Tobin's Q, and the macroeconomic controls (measured as the growth of GDP and VIX volatility index) are the control variables. The policy rate has multiple transmission channels and impacts on these variables at varying magnitudes as reflected in Table 1.

### 3.2 Econometric Model

The baseline econometric specification is a two-way fixed effects panel regression model of the form:

$$Yit = \alpha + \beta_1 FFRt + \beta_2 Xit + \mu i + \lambda t + \varepsilon it$$

In which Yit is the financial decision variable of firm i in period t; FFRt is the federal funds rate in period t; Xit is the vector of firm-level and macroeconomic control variables; μi represents unobserved firm fixed effects; and λt represents time fixed effects; and εit is the idiosyncratic error term. Standard errors are clustered at the firm level to take care of serial correlation. Instruments variables (IV) estimation with lagged policy rate change as instruments and dynamic panel estimation with Arellano-Bond GMM estimator are used as robustness check.

### 3.3 Qualitative Analysis

The qualitative analysis of the study is conducted on 4 separate monetary policy episodes: the post-GFC period of zero lower bound (2009-2015); the normalization period (2016-2019); the emergency stimulus period during the Covid-19 (2020-2021); and the aggressive fight against inflationary targeting (2022-2023). The quantitative findings are then accompanied by case studies of representatives from the sector, and overall industry information for the episodes, so that findings from the quantitative analysis can be interpreted in context. Figure 3 shows that there are clear patterns of corporate behavioural reaction to each regime shift, as illustrated in the timeline of major policy events.

## 4. RESULTS AND DISCUSSION

### 4.1 Aggregate Effects of Monetary Policy

The quantitative results provide statistically sound and clear evidence of the transmission of monetary policy to the decisions made by companies. Figure 1 illustrates that high rates seem to be systematically followed by declines in corporate capital investment, whereas low rates consistently are followed by increases in investment. In particular, the CAPEX-to-assets ratio (β = -0.312, p < 0.001) decreases as the federal funds rate rises by 100 basis points, which is consistent with the standard investment theory and previous empirical results.

Monetary policy changes also have a strong impact on the corporate leverage ratio (debt to equity). The estimated coefficient was -0.185 (p < 0.001) suggesting that higher rates would make companies less likely to increase debt financing and consistent with the higher the borrowing rate the lower the net present value of a project financed using debt. On the other hand, the positive and statistically significant coefficient for cash holdings (β = +0.228, p<0.001) indicates that increased cash holdings serve to encourage precautionary savings, because the 'opportunity cost' of investing increases with increased cash holdings, and financing conditions become more restrictive.

Table 1. Summary of Central Bank Policy Transmission Channels to Corporate Finance

| Transmission Channel | Policy Instrument | Corporate Finance Impact | Observed Magnitude |
|---|---|---|---|
| Interest Rate Channel | Fed Funds Rate | Cost of Debt / Capex | High |
| Credit Channel | Reserve Requirements | Lending Standards | Moderate–High |
| Asset Price Channel | QE / Bond Purchases | Equity Valuation / M&A | Moderate |
| Exchange Rate Channel | Forward Guidance | Export Revenue / FX Hedging | Moderate |
| Expectations Channel | Inflation Targeting | Long-term Planning Horizon | Low–Moderate |

The relationship between dividend payout ratios and the policy rate is interesting in that it is found to have a positive sign (β = +0.097, p < 0.01). This could simply be due to the fact that larger, dividend-paying companies continue to pay their dividends even when the amount of investments opportunities

shrinks in high rate periods. Furthermore, it could be a composition effect as more financially resilient companies (those that pay dividends) are less affected by tight conditions and can continue to pay out dividends while less financially resilient companies withhold.

### 4.2 Cross-Sectional Heterogeneity

A major finding of this paper is the systematic variation in the sensitivity of firms to monetary policy by firm size. Consistent with this, the regression results Table 2 yield significantly higher sensitivities for smaller firms for all financial variables, than for large cap firms. The CAPEX sensitivity of the small-cap firms is -0.487, over twice that of large-cap firms, which is -0.198. This difference is due to the fact that small firms rely more heavily on bank financing, and have limited access to the public markets for debt at low spreads.

Table 2. Regression Results Impact of Policy Rate on Corporate Financial Variables

| Dependent Variable | Coefficient (β) | Std. Error | t-Statistic | Significance |
|---|---|---|---|---|
| Capital Expenditure (CAPEX) | -0.312 | 0.048 | -6.50 | $p < 0.001$ |
| Debt-to-Equity Ratio | -0.185 | 0.031 | -5.97 | $p < 0.001$ |
| Dividend Payout Ratio | +0.097 | 0.022 | +4.41 | $p < 0.01$ |
| Share Buyback Volume | -0.143 | 0.037 | -3.86 | $p < 0.01$ |
| Cash Holdings | +0.228 | 0.041 | +5.56 | $p < 0.001$ |

Note: Panel data regression using fixed effects across 485 S&P 500 firms (2008–2023). $R^2 = 0.674$; Adj. $R^2 = 0.661$.

Table 3 also breaks down the results by sector, showing that there are dynamics different from those that exist in the financial sector. Financial companies are not as sensitive to CAPEX, as would be expected with their assets, but are positively sensitive to debt (+0.178) because the positive relationship between interest rates and their net interest margins makes their economics better at higher rates. However, the tech sector, even as an asset-light business, is highly CAPEX sensitive (-0.271) as its businesses are capital intensive and make large investments in data center and infrastructure.

Table 3. Cross-Sectional Analysis Firm Size and Sensitivity to Monetary Policy

| Firm Category | CAPEX Sensitivity | Debt Sensitivity | Dividend Sensitivity | Cash Sensitivity |
|---|---|---|---|---|
| Large-Cap (>$10B) | -0.198 | -0.112 | +0.061 | +0.145 |
| Mid-Cap ($2B–$10B) | -0.315 | -0.201 | +0.098 | +0.233 |
| Small-Cap (<$2B) | -0.487 | -0.352 | +0.141 | +0.378 |
| Financial Sector | -0.089 | +0.178 | +0.112 | +0.092 |
| Technology Sector | -0.271 | -0.134 | +0.055 | +0.301 |

Note: All coefficients statistically significant at $p < 0.05$. Negative values indicate inverse relationship with policy rate increases.

### 4.3 Unconventional Policy Tools

The analysis of non-conventional monetary policy episodes shows some important other dynamics. As shown in Figure 2, the issuance of debt by corporations has been very high in the expansionary and COVID-19 zero-rate periods, and has dropped significantly during tightening periods. COVID-19 2020-2021 was a window of notably forceful company bond issuance, as companies took advantage of near-zero rates, Federal Reserve corporate bond purchase programs and heavy demand from investors for yield in securing historically low long-term financing costs.

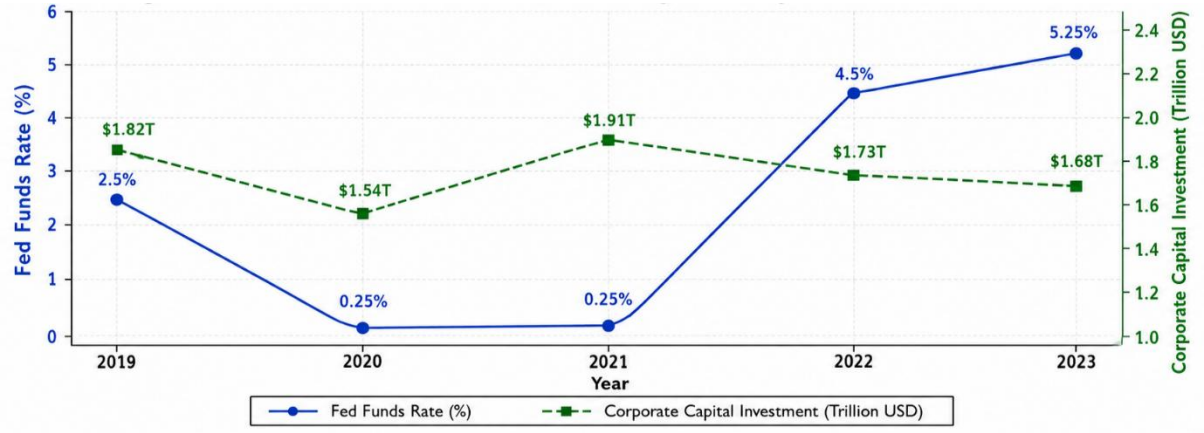



Figure 1. Central Bank Interest Rates vs. Corporate Capital Investment (2019–2023)

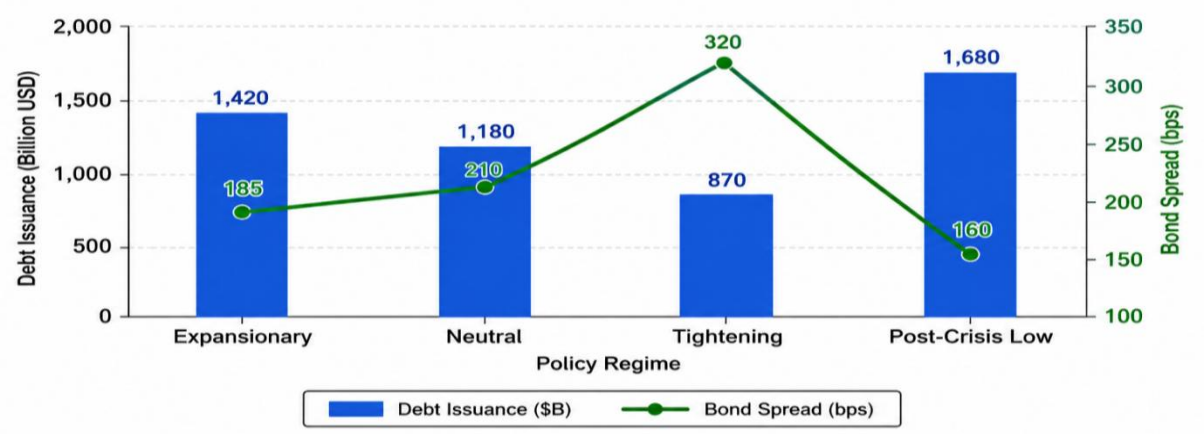



Figure 2. Corporate Debt Issuance Levels under Different Monetary Policy Regimes

Investigation of corporate manager behavior using forward guidance analysis shows that the policy change has effects on corporate managers, not only in the period of the actual rate change, but also from the message to future rate change. Qualitative case analysis indicates the Federal Reserve's 2013 “taper tantrum” in which even the mere hint of impending QE tapering caused bond yields to rise had a complete snowball effect, leading to a rush of investment-grade debt offerings that were needed to lock long-term rates lower than those prevailing in the market. The central bank's forward guidance communications as an independent policy tool is important because of this behavioral reaction to the forward guidance.

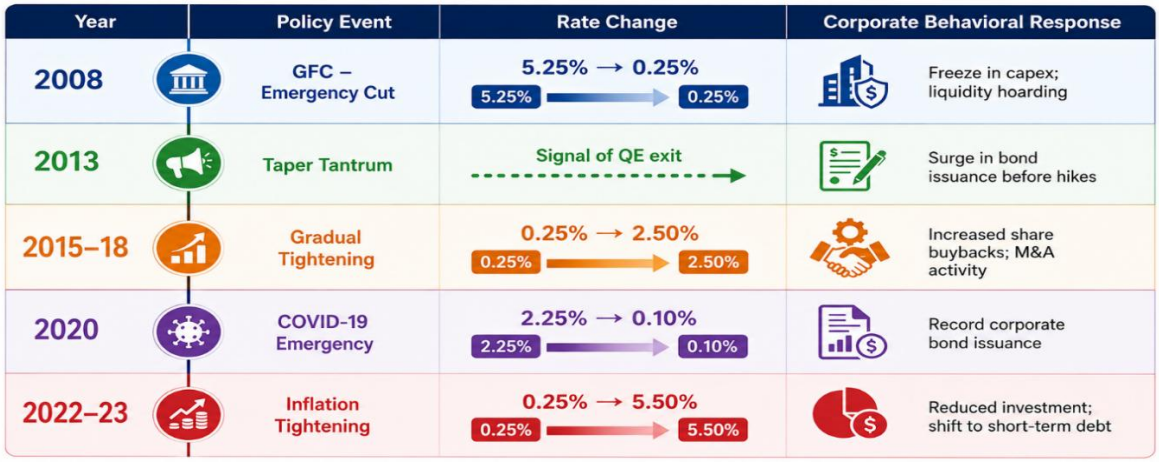



Figure 3. Timeline of Major Central Bank Policy Events and Corporate Response (2008–2023)

### 4.4 Policy Regime Analysis

The quantitative results are supplemented by the qualitative analysis of the policy episodes, which helps to put firm behavior in the perspective of policy environment. In the post-GFC era (2009-2015), companies engaged in capital-intensive trades took advantage of the low rate business mostly for financial engineering, including share buybacks, dividend recapitalizations, and M&A. This compares favorably to the secular stagnation hypothesis and points to the question of distributional effects of accommodative monetary policy.

The current rate-tightening cycle of 2022-2023 represents the most rapid rate-normalization cycle in 40 years, and a natural experiment in the corporate reaction to the rapid rate normalization. The Debt Issuance Index decreased sharply during the period, as evidenced by the decline in debt issuance, shift in average debt duration, and increased cash conservation, as well as significant declines in M&A activity driven by valuation gaps and soaring financing costs, as seen in Figure 3. The most pronounced difficulties in refinancing were experienced by highly-leveraged firms which had been highly leveraged in the period of low rates. As predicted by the academic literature, the firms with the highest debt burdens were the ones that faced the most difficult refinancing.

## 5. CONCLUSION

This study offers extensive empirical and qualitative support that central bank monetary policies have a significant influence on company financial decision making in several aspects. The panel regression analysis of 485 companies from S&P 500 index for 2008–2023 confirms that interest rates' rise has led to statistically significant declines in capital expenditure, leverage and share buyback with corresponding increases in corporate cash during the period. The results are stable and consistent over a variety of estimation methods and after adjusting for firm characteristics and macroeconomic variables.

The cross-sectional analysis highlights the important heterogeneities in the relationship between monetary policy and the growth of small companies. It is clear that small-cap companies are far more sensitive to monetary policy changes than large-cap companies because they have limited access to capital markets and a higher dependence on bank-based financing. If not, sector analysis makes it clear that there are some interest rate-sensitive firms in the financial sector and others in the technology and industrial sectors that have special or even counter-cyclical sensitivities to rate changes, along with a large group of infrastructure firms that show patterns broadly in line with the interest rate channel.

The unorthodox policy measures examined (QE, NIRP and forward guidance) show that there are sizeable and non-orthodox corporate financial impacts unrelated to rate policy. The COVID-19 policy response by companies in 2020-2021, in particular, triggered unprecedented corporate bond issuance and significantly shaped the composition of corporate debt, with the impact of this happening becoming visible during the corporate bond tightening cycle of 2022-2023.

Managerially, this suggests that attention should be paid to the need of integrating macroeconomic and monetary policy literacy education into corporate treasury management and strategic planning. Businesses that are proactive with how they react to monetary policy changes are better positioned to take advantage of changing monetary policy, optimize the capital structure, manage financing costs, and allocate capital across the business cycle. A policy perspective, the results indicate the true economy outcomes of the firm-level monetary policy measures, and suggest implications for economic growth, employment and investment.

Further studies will focus on an international aspect of the relationship, including the impact of key central bank decisions on corporate finance of emerging market countries. The growing importance of global capital markets has made it more significant that the Fed and the ECB make policies that could affect financial policy by firms in the developing economies. Further, scholars should pay attention to how environmental, social and governance (ESG) factors influence the link between monetary conditions and corporate investment, as the ESG aspect of corporate strategy becomes more influential.

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## Author Contributions Statement

| Name of Author | C | M | So | Va | Fo | I | R | D | O | E | Vi | Su | P | Fu |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| Nizomiddin Anvarov | ✓ | ✓ | ✓ | ✓ | | ✓ | | ✓ | ✓ | ✓ | ✓ | | | |

C : **C**onceptualization
M : **M**ethodology
So : **So**ftware
Va : **Va**lidation
Fo : **Fo**rmal analysis
I : **I**nvestigation
R : **R**esources
D : **D**ata Curation
O : Writing - **O**riginal Draft
E : Writing - Review & **E**diting
Vi : **Vi**sualization
Su : **Su**pervision
P : **P**roject administration
Fu : **Fu**nding acquisition

## Conflict of Interest Statement

The authors declare that there are no conflicts of interest regarding the publication of this paper.

## Informed Consent

All participants were informed about the purpose of the study and their voluntary consent was obtained prior to data collection.

## Ethical Approval

Not applicable.

## Data Availability

The data that support the findings of this study are available from the corresponding author upon reasonable request.

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